DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 98-0084
INDIANA CORPORATE INCOME TAX
For the 1990, 1991, 1992, and 1993 Tax Years

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ISSUES

I. Verification of Interest Derived from Government Student Loan Marketing Association Obligations.

Authority: IC 6-2.1-3-1; IC 6-3-1-3.5(b)(1); Department of Revenue Information Bulletin #19.

Taxpayer has submitted information purportedly verifying that interest payments received during the tax years at issue were the results of its investment in a Student Loan Marketing Association.

II. Apportionment of Taxpayer's Payroll Based on Mileage.

Authority: IC 6-3-2-2(l); Indiana Dept. of State Revenue v. E.W. Bohren, Inc., 178 N.E.2d 438 (Ind. 1961).

Taxpayer argues the determination that it could not apportion the payroll factor based upon mileage driven within the state of Indiana was erroneous.

III. Application of the Throw-back Rule to Income Received by Taxpayer's Subsidiaries.

Authority: 15 U.S.C.S. § 381; IC 6-3-2-2(f); IC 6-3-2-2(n); Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); 45 IAC 3.1-1-64.

Taxpayer argues the Department's decision to adjust the sales numerators of two of the taxpayer's subsidiaries was based upon an erroneous understanding of the facts.

STATEMENT OF FACTS

Taxpayer and its subsidiaries operate a number of businesses primarily related to the provision of specialized transportation services. The taxpayer maintains an out-of-state headquarters but owns real and personal property within Indiana and conducts business within the state.

DISCUSSION

I. Verification of Interest Derived from Government Student Loan Marketing Association Obligations.

During its original audit, the taxpayer was not permitted to deduct certain interest income received from investments in a "student loan marketing association." The taxpayer asserted that the Department erred in making the disallowance arguing that the interest was exempt because it was derived directly from United States government obligations. IC 6-2.1-3-1 exempts from the state's corporate income tax government securities stating that "Interest or other earnings paid upon bonds or other securities issued by the United States are exempt from the gross income tax to the extent the United States Constitution prohibits the taxation of that gross income." The state's provision for its adjusted gross income contains a parallel provision at IC 6-3-1-3.5(b)(1) which permits corporations to adjust their taxable income by "[s]ubtract[ing] income that is exempt from taxation under IC 6-3 by the Constitution and statutes of the United States."

Additionally, the issue raised by the taxpayer is specifically addressed within the Department's Indiana Income Tax Information Bulletin #19. That Bulletin states that "For purposes of the Gross Income Tax and the Adjusted Gross Income Tax Act, obligations issued by the following organizations are considered direct United States Government obligations specifically exempted from state income taxation by federal law." Included within the listing of exempt obligations which follows is a reference to "Student Loan Marketing Association" (SLMA) obligations. The original Letter of Findings sustained the taxpayer "to the extent that the interest [could] be verified to be from SMLA interest. At the rehearing, taxpayer presented extensive documentation which purportedly substantiates the income as derived from SMLA obligations. That documentation includes taxpayer's records – referred to as the taxpayer's "investment system" - for the 1990, 1991, and 1992 tax years. That documentation includes a memo from the taxpayer's assistant treasurer for cash administration which certifies that securities described by a "SLMA, SLMAD, SMA or any variance of the letters SLMA" describe "the purchase of Student Loan Marketing Association discount notes, otherwise known as Sallie Mae Notes." Taxpayer Memo, Jan. 24, 2001.

Although the documentation offered by the taxpayer may indeed substantiate the taxpayer's assertion, examination of that documentation and verification of taxpayer's "investment system" notations is not a legal issue coming within the purview of a Supplemental Letter of Findings. Accordingly, the taxpayer is left with the determination found within the original Letter of Findings and must await the results of a supplemental audit.

FINDING

The taxpayer is sustained to the extent that the interest can be verified as derived from government SLMA obligations.

II. Apportionment of Taxpayer's Payroll Based on Mileage.

The taxpayer originally protested the Department's determination that two of its subsidiaries were not entitled to apportion their payroll using a mileage percentage. Following the original administrative hearing and the original Letter of Findings affirming that determination, the taxpayer has raised the identical issue arguing that taxpayer's subsidiaries should be permitted to apportion their payroll pursuant to 45 IAC 3.1-1-63 or 45 IAC 3.1-1-49. In the alternative, the taxpayer argues that the Department should exercise its discretion and allow the taxpayer to apportion their payroll pursuant to IC 6-3-2-2(l).

Taxpayer operates as a licensed common carrier to provide moving and specialized transportation services for its customers. Once an agreement is reached with a customer to provide those services, taxpayer arranges with one of its two subsidiaries – depending on the nature of the transportation required – to provide the driver and equipment needed to implement the agreement. The subsidiaries are not independently licensed to operate as common carriers. Taxpayer is the single entity responsible for providing freight insurance for its customers and is liable to the customers if a shipment is lost, damaged, or fails to reach its destination. The subsidiaries do not share in this responsibility to taxpayer's customers and do not provide insurance coverage. Taxpayer compensates its subsidiaries by paying a fixed mileage cost to cover the cost of the subsidiaries' drivers and equipment.

45 IAC 3.1-1-63(C) requires that "[t]he total revenue dollars from transportation (both intrastate and inter-state) are to be assigned to states traversed on the basis of class or category mileage in each state in which or through the freight or passengers move."

45 IAC 3.1-1-49(c) provides that "[e]mployees engaged in the transportation of persons and/or materials as part of the taxpayer's regular business activities, i.e., truck or bus drivers, shall have their wages assigned to this state based on miles traveled in this state."

However, much as taxpayer may attempt to define, explain, or characterize the nature of its subsidiaries' business operations, it cannot get past the conclusion reached with the original Letter of Findings. Taxpayer's subsidiaries are not "transportation companies" as contemplated within the purview of either 45 IAC 3.1-1-63 or 45 IAC 3.1-1-49. Consistent with this conclusion is the fact that the subsidiaries are not licensed common carriers and are not responsible to customers in the event of a lost or damaged shipment. If a potential customer wished to purchase transportation services, it would not be able to do so by dealing directly with taxpayer's subsidiaries. If taxpayer's subsidiaries spontaneously decided to provide transportation services to a client, they would be unable to do so because the subsidiaries are limited to providing a driver and certain equipment neither of which, together or alone, is sufficient to provide the desired transportation service. Taxpayer's subsidiaries are more properly

characterized as leasing companies than as providers of transportation services. This distinction is made plain by the citation, within the original Letter of Findings, to Indiana Dept. of State Revenue v. E.W. Bohren, Inc., 178 N.E.2d 438 (Ind. 1961) in which the court stated that "appellee's income is not derived from operating a truck line or carrier in interstate commerce, but rather the receipts are received as a result of the appellee's property and equipment under a contract or lease to an interstate carrier." Id. at 440. Even given the taxpayer's objections to the applicability of Bohren – that Bohren involved the application of the state's gross income tax rather than its adjusted gross income tax – the inescapable conclusion, that taxpayer's subsidiaries are not in the business of providing transportation services, remains.

Taxpayer reasserts an alternative argument, that the Department should permit taxpayer to apportion its subsidiaries' payroll factor based on mileage, under the provisions set forth in IC 6-3-2-2(l). Under that statutory provision, "[I]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived within the state of Indiana, the taxpayer may petition for or the department may require, if reasonable: (1) separate accounting; (2) the exclusion of any one . . . or more of the factors; (3) the inclusion of one . . . or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." Other than stating that it could have structured its business interests in such a way as to take advantage of the apportionment provisions available under 45 IAC 3.1-1-63 or 45 IAC 3.1-1-49, taxpayer has not established in what manner the determination within the original Letter of Findings results in an allocation of the taxpayer's income which "[does] not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . ." IC 6-3-2-2(l). In the absence of a substantive demonstration on the part of the taxpayer that its subsidiaries' income has been distorted, that its has been subjected to a double taxation, or that its subsidiaries' income has been inequitably apportioned, the Department must decline the opportunity to exercise its discretion available under the provisions of IC 6-3-2-2(l).

FINDING

The taxpayer's protest is respectfully denied.

III. Application of the Throw-back Rule to Income Received by Taxpayer's Subsidiaries.

The first of taxpayer's subsidiaries (hereinafter "Subsidiary One") provides distribution, warehouse, and staging activities for third-party customers. The second of taxpayer's subsidiaries (hereinafter "Subsidiary Two") provides sales and computer services to the taxpayer's local agents. Subsidiary Two sells both computer hardware and software to these agents. The audit made adjustments to the Subsidiary One and Subsidiary Two's sales numerators stating that neither subsidiary has "payroll or property in any state except Indiana" and that the subsidiaries' income should be attributed to Indiana. The original Letter of Findings affirmed that determination.

Taxpayer argues that the original Letter of Findings improperly determined that the state's throw-back rule was applicable to certain of its subsidiaries' sales to out-of-state locations. The taxpayer maintains that the throw-back rule should not apply because the out-of-state activities of the subsidiaries exceeded the "mere solicitation" standard set out in Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980). According to the taxpayer, its subsidiaries' out-of-state activities included "extensive customer service, maintenance, and marketing activities." Taxpayer Memo, Jan. 24, 2001, p. 5. Alternatively, the taxpayer argues that not all of its subsidiaries' sales income should be attributed to the state of Indiana under the provisions of IC 6-3-2-2(f).

15 U.S.C.S. § 381 (Public Law 86-272) prohibits all states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales. 15 U.S.C.S § 381(a), (c). The effect of the throw-back rule is to revert sales receipts back to the state from where the goods were shipped in those situations where 15 U.S.C.S. § 381 deprives the purchaser's own state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 permits Indiana to tax out-of-state business activities, without violating the Commerce Clause and without the possibility of subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the authority to tax income derived from the sale of tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then the income is "thrown-back" to the originating state.

Taxpayer argues that the original Letter of Findings failed to properly apply the apportionment standard set out in IC 6-3-2-2(n) which provides that "[f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." Taxpayer argues that the original Letter of Findings failed to address IC 6-3-2-2(n)(2), because, even though the taxpayer's subsidiaries did not pay taxes to the foreign states, the subsidiaries were *subject* to the foreign state's taxing authority. Taxpayer asserts that it was subject to "several" foreign states' taxing authority because it established nexus within those "several" states by "performing extensive customer service, maintenance, and marketing activities." Taxpayer Memo, Jan. 24, 2001, p. 5. In addition, the taxpayer argues that taxpayer's subsidiaries "[had] payroll and property in states other than Indiana." Id.

Subsidiary One provides certain warehousing services to third-party customers. Because taxpayer does not own warehousing space itself, Subsidiary One is essentially selling customers its expertise and experience in the moving, storage, and marshalling of customer's goods. Subsidiary One's on-site activities consist of storing, tracking, marshalling, and delivery services performed on behalf of the third-party customer. A typical transaction is one in which Subsidiary One locates and takes possession of warehouse space appropriate to the needs of a customer, assumes continuing management of the warehouse space, and arranges for the transfer of customer's goods to that warehouse. Upon delivery of customer's goods, Subsidiary One may –

at customer's discretion – provide certain additional services such as assembly, installation, damage inspection, and repair.

Subsidiary One has provided, based upon the taxpayer's own internal review, an apportionment of the amount of time Subsidiary One's employees spend on sales and other activities. According to the taxpayer, Subsidiary One's employees activities can be apportioned as follows: 20 percent sales, 10 percent pickup and delivery of goods, 35 percent warehousing and staging, and 35 percent setup services. Taxpayer Letter, Feb. 12, p. 2.

Subsidiary Two is constituted to provide computer and computer related services to the taxpayer's own local agents. All of Subsidiary Two's sales are "in-house" sales made to taxpayer's 850 nationwide local agents. Subsidiary Two sells computers, software developed by Subsidiary Two, and software produced by unrelated third-party vendors. Taxpayer maintains that its out-of-state activities exceed the "mere solicitation" standard because, owing to the nature of the Subsidiary Two's business, simple solicitation would be insufficient to fully complete a customer transaction. According to the taxpayer, an initial transaction involves an on-site visit to assist with installation and the provision of on-site customer services. Taxpayer asserts that it provides additional on-site services as both hardware and software upgrades become available. In addition, taxpayer maintains that Subsidiary Two provides its customers (local agents) continuous on-site assistance to the extent that its customer experience problems with Subsidiary Two's various products.

Taxpayer has attempted to quantify Subsidiary Two's representative's activities. According to taxpayer, Subsidiary Two's employee's activities can be apportioned as follows: 20 percent sales, 15 percent hardware installation, 20 percent software installation, 10 percent software upgrades, and 35 percent support services. Taxpayer Letter, Feb. 12, p. 3. Taxpayer support services can be further apportioned to on-site and off-site support services. Three-quarter's of taxpayer's services are provided to customer by phone while the remaining one-quarter is allocable to actual, on-site support services. Taxpayer email, March, 5, 2001.

The taxpayer is correct in its assertion that Continental, 399 N.E.2d 754, defines those activities which do and do not exceed the 15 U.S.C.S. § 381 "mere solicitation standard." In that case, the court held that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance and training . . . ." Id. at 759. Further, "solicitation must be limited to those acts which lead to the placing of orders and does not include those acts which follow as a result of the transaction." Id. The court set out examples of activity which exceeded "mere solicitation" including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property [] and associated local business activity for purposes not related to soliciting orders within the taxing state." Id.

In Continental, the court held that the taxpayer's activities within the foreign state exceeded solicitation because taxpayer's activities "[did] not lead to the placing of orders but follow[ed] as

a natural result of the transaction." Id. Those activities included the taxpayer's "salesmen making adjustment on complaints, [and] salesmen giving customers technical assistance . . . ." Id.

The "mere solicitation" standard was refined by the Supreme Court in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992). The Court concluded that "although solicitation covered more than what was strictly essential to making requests for purchases, the fact that an activity is performed by salespersons does not automatically convert that activity into solicitation." Id. at 2456-57. The Court held that whether the taxpayer's in-state activity was sufficiently de minimis to avoid the loss of taxpayer immunity, conferred by 15 U.S.C.S. § 381, depended on whether the activity establishes a "non-trivial additional connection with the taxing State." Id. at 2458. In Wrigley, the Court determined that the taxpayer's sales representatives' activities, consisting of replacing stale gum at retail locations, was an activity outside 15 U.S.C.S. § 381 immunity. Id. at 2458-59. The Court held that although the representatives' activity could be said to facilitate the sales, it did not facilitate the *requesting* of sales and was not ancillary to the solicitation of sales. Id. at 2459 (Emphasis added). Therefore, because taxpayer's practice of having its representatives rotate stocks of stale gum was an activity outside the solicitation of sales, taxpayer brought itself outside the scope of 15 U.S.C.S. § 381 immunity and subjected itself to the local net income tax. Id. at 2460.

Taxpayer contends that Subsidiary One's out-of-state activities consist of locating warehouse space, securing warehouse space, managing that warehouse space and its customer's goods, as well as performing other activities related to the care and ultimate disposition of warehoused goods. Specifically, Subsidiary One . . .

> . . . provides for and manages the complete warehousing process for the customer. When the goods are ready for delivery[y], as part its services, [Subsidiary One] . . . provides delivery and customer setup including such on-site services as assembly, installation, damage inspection, and repair.

Taxpayer argues that these out-of-state activities exceed the "mere solicitation" protections of, and the de minimis exceptions to P.L. 86-272. Consequently, any income derived from these activities should be apportioned to the states where the activities are performed and not "thrown-back" to Indiana.

Audit rejected taxpayer's contention that this income was derived from the performance of out-of-state activities *because Audit was unable to identify any Subsidiary One employees, income-producing property, or other indicia of income producing activities by Subsidiary One within these other states.* Consequently, Audit characterized the income received by Subsidiary One as commission income – i.e., income properly apportioned to Indiana.

In this instance, the absence of payroll and property factors, alone, is not dispositive. At hearing, taxpayer provided information suggesting that activities performed out-of-state by Subsidiary One were sufficient to create nexus – and to establish reporting requirements – in other states. Audit, therefore, will examine the newly submitted materials, and any other information deemed relevant, to determine whether Subsidiary One's employees, or agents, were engaged in income-producing activities in these other states.

Subsidiary Two's out-of-state activities, however, do clearly exceed the "mere solicitation" of orders for its computer services. The initial solicitation of the order is the first step in an ongoing, complex, collaborative endeavor whereby Subsidiary Two provides substantial on-site, installation, update, and training services. These activities - all of which are ancillary to the initial solicitation of customer's business - take place over an extended period of time and involve extensive on-site activities by Subsidiary Two's representatives.

FINDING

With regards to Subsidiary One's out-of-state activities, taxpayer's protest is sustained subject to audit verification. With regard to Subsidiary Two, taxpayer protest is sustained.

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